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# "GOVERNMENTAL REGULATION OF THE DISTRIBUTION OF INVESTMENT COMPANY SHARES"

**ADDRESS**

of

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of

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There is an old rule of thumb for testing the adequacy of the lead in a newspaper story, and that is whether it answers five questions -- the five W's: who, what, when, where and why. My subject today is the distribution of investment company shares. In considering how to treat this subject I decided to ask myself three questions and then try to answer them: where have we come from, where are we now, and where do we go from here. I want to outline in a general way the past developments in this field and how the state and federal governments have met them; to report what we at the Commission have been doing during the eleven months since the Investment Company Act of 1940 became effective; and, finally, to point out certain jobs that remain to be done and that can be best done through the cooperation of your association and its members and the Securities and Exchange Commission.

In considering the subject of investment company distribution, I have been constantly impressed by one fact: how short a history it has. Until about 15 years ago there was no substantial distribution of these shares in this country. As for regulation, even general securities regulation, the oldest of your state commissions has been in existence only some 30 years, while federal statutes in this field have been on the books only a little over 8 years. By historical standards we are not dealing with an old problem here, but with a novel one.

As a convenient way of considering these 15 years of history, I suggest that we look at the situation with respect to investment companies and their regulation as it was in 1925, and then in 1930, and then in 1935, and then in 1940.

Back in 1925 things were pretty peaceful. In fact a trend toward the formation of investment companies was beginning -- the number organized annually had steadily increased from 6 in the year 1921 to 46 in 1925 -- but the trend was not yet clearly defined. Most of the companies formed during this period were of the closed-end type. Three open-end companies were organized in 1924 and 1925, but they had not yet ventured far from Boston. Investors Syndicate and Fidelity Investment Association were in existence and selling face-amount certificates, but not very many certificates. Of course none of these companies was then subject to federal regulation, and while most of them were subject in some measure to Blue-Sky requirements, the state statutes and regulations, so far as appears, did not treat them much differently from the general run of corporations and business trusts. It was a peaceful time. The Commissioners on Uniform State Laws were working in a leisurely way upon a uniform Blue-Sky act; they had started in 1922 and their fourth and final draft was to be approved at the Memphis Conference of 1929.

The year 1930 brings a much different picture. The stock market boom had come and gone, and with it a good many investment companies, mostly of the closed-end type. These companies raised between 1927 and 1929 approximately $2,300,000,000 from the sale of new securities. Their assets rose from $550,000,000 in 1927 to almost $2,600,000,000 in 1929. This is the period during which United Founders Corporation and its affiliated companies alone raised approximately $500,000,000 from the sale of their securities to 90,000 stockholders located in 35 states. It is also the period in which the stock of United Founders dropped from a high of 75 (in 1929) to 6 (in 1930) and finally (in 1931) to 1-3/8. There is no need to relate again the failures and scandals of those years, either in the investment company field or other areas of the securities business.

I have often wondered what it must have been like to be a state securities commissioner in those years of the boom. Probably the average commissioner felt much like the little Dutch boy with his finger in the dike. Prior to 1929 there were 34 Blue-Sky laws of one type or another. That means that there were 34 fingers available for the dike. I suspect that there were many more than 34 holes in that dike.

Next we have 1935, an important year. The effect of the boom period on investment companies was to bring the management companies into disrepute, and to cause the development of the fixed type investment trust, from which the management factor was absent. Between 1930 and 1935 the fixed trusts had had their day. The distribution of the shares of these trusts reached its peak in 1930 and 1931 when $600,000,000 of their shares were sold. The sale of the fixed trust shares gave rise to a number of statutes and regulations which may fittingly serve as their epitaph. For example, North Carolina adopted in 1933 a regulation prohibiting the charging of any sales load on the switching of trust shares. Incidentally, the principle of the North Carolina rule was carried into Section 11 of the Investment Company Act of 1940, which covers exchanges of all redeemable securities, whether issued by open-end management companies or unit trusts, and also of face-amount certificates.

North Carolina was not the only state to deal specifically with the fixed trusts during this period. Iowa adopted a rule in 1931 restricting the sales load on fixed trust shares, and regulatory statutes were enacted in Wisconsin in 1933, and in Illinois in 1935. California in 1932 had adopted regulations treating not only with the registration of these fixed trusts, but also with management companies. Presumably other states also imposed restrictions as a matter of administrative practice, without embodying them in any formal rule.

With the decline of the fixed trust, the open-end management company came into prominence. Of the $586,000,000 gross proceeds from the sale of securities of open-end management companies from 1927 to 1936, $360,000,000, or 61 percent, was paid in between 1933 and 1936. During these years the distribution of the periodic payment plan certificates likewise became popular.

By 1935, also, we have the federal government in the picture. The Securities Act of 1933 had been passed. The Securities Exchange Act of 1934 had been passed, creating the Securities and Exchange Commission. Form C-1 had been promulgated under the 1933 Act and Forms 15 and 17 under the 1934 Act, dealing specifically with various types of investment trusts and companies. The great investigation of the Senate Banking and Currency Committee, (commonly known, after the Committee's counsel, as the Pecora Investigation) had been concluded, not without mention of investment companies and their inherent dangers. And in 1935 the Public Utility Holding Company Act was passed, Section 30 of which directed the Commission to make a study of investment trusts and investment companies and report back to the Congress.

And so we come to 1940 and a still different picture. By this time, the activities of almost all types of investment companies had been brought under comprehensive regulation, both state and federal. What had been only a trend in 1935 had become an actuality during the succeeding five years.

The most conspicuous example of comprehensive state regulation during the period 1935 to 1940 was, of course, Ohio's Regulation Q-3, which has since been adopted or is being followed administratively by a large number of states. At your Association's convention in 1939, John B. Martin of the Ohio Securities Division explained the origins and scope of this regulation, and I shall not attempt to go over the same ground. It covers a great number of subjects, such

as self dealing, sales load, management contracts, custodianship, diversification, redemption, dividend disbursements and reports to shareholders. It is worth noting that in promulgating Q-3 the Ohio Securities Division leaned heavily on the great mass of information which the SEC had assembled in the course of its study of these companies pursuant to Section 30 of the Public Utility Holding Company Act of 1935.

The year 1940 also brought the enactment of a federal statute, the Investment Company Act of 1940. This legislation covers all types of investment companies -- management companies, both closed-and open-end, diversified and non-diversified, unit investment trusts, periodic payment plans and face-amount certificate companies. It is concerned not merely with the distribution of investment company shares, but with many other matters. Later on I will be glad to try to answer any questions which you may have with regard to the operation of the Act upon matters other than distribution. For the present, let me stick to my subject, and discuss only those portions of the statute which have a bearing on the distribution of shares. That means, as a practical matter, that the following remarks will be confined to open-end companies, including periodic payment plans. The securities of closed-end companies are not being generally distributed at the present time, while the face-amount certificate companies present problems of so special a character as to require an entirely separate discussion.

There are a number of ways in which the Investment Company Act has an indirect impact upon distribution, in addition to those provisions which deal expressly with the subject. I shall not go into any of the more subtle ways in which distribution is affected by the statute, but will confine myself to those provisions where the connection is clear.

It is hardly necessary to say that the requirement of the Act that a newly organized company have a net worth of $100,000 before making a public offering of its securities has an effect upon distribution. It happens that no new management companies have been formed, to our knowledge, since the effective date of the Investment Company Act. To what extent this is due to general business conditions and to what extent to the provisions of the Act, it is of course impossible to say; but since the Commission has received a number of inquiries as to the statutory provisions bearing upon the formation of new companies, it is reasonable to assume that the Act is partly responsible for this circumstance. It is a comment on the shoe-string basis upon which these companies are sometimes organized that a net worth requirement of only $100,000 can be a deterrent.

With regard to sales load, the Act itself does not impose any restrictions at the present time except on periodic payment plan certificates. The Act authorizes the SEC to prescribe rules to prevent "unconscionable or grossly excessive" sales loads but this provision does not become effective until November 1, 1941. During the intervening year the promulgation of rules on this subject was expressly committed by the statute to national securities associations registered under the so-called Maloney Amendment to the Securities Exchange Act of 1934. The National Association of Securities Dealers, Inc., which is the only association presently registered under the Maloney Amendment has added to its Rules of Fair Practice a new rule, Rule 26, which became effective in June of this year and which provides in part that no member of the association who is an underwriter shall participate in the offering or sale of any security of an open-end company "if the public offering price includes

a gross selling commission or load . . . which is unfair, taking into consideration all relevant circumstances, including the current marketability of such security and all expenses involved." This rule is more conspicuous for its piety than its substance. Moreover, even if on November 1st of this year the Commission should decide to adopt its own rules as to sales load, they must be limited, as I have pointed out, to the prevention of "unconscionable or grossly excessive" sales loads. This is a field, therefore, to which the states can appropriately give careful attention (as to a considerable extent they have in the past), not only because their powers are generally greaterthan those which we possess, but also because a large share of the sales load is given to the local dealer with whose problems the state commissions are naturally more familiar than we in Washington can be.

With respect to periodic payment plans, the Act contains definite sales load limitations. These may be generally described as an overall limitation of 9% of total payments to be made on a certificate, roughly half of which may be taken out during the first year of the plan and the balance of which must be spread equally over the remaining years. The Commission is authorized by rule, regulation or order to relax the statutory limitations. To date, of the fifty-six registered companies issuing periodic payment plan certificates, twelve have filed applications for such relaxation; of these applications, two have been withdrawn and the remainder are now pending. On 8 of the applications, which were consolidated, a hearing has been held and oral argument had before the Commission.

Another topic with respect to which the Commission has rule-making authority which does not become effective until November 1st of this year, and with respect to which the N A S D has in the meantime adopted regulations, as contemplated by the Act, is the pricing of securities issued by

open-end companies. The professed purpose of these regulations (which constitute the major part of N A S D Rule 26, to which I have referred) is to eliminate or reduce so far as is reasonably practicable any dilution resulting from the failure to reflect promptly, in the public offering price of the shares, changes in underlying asset value caused by market fluctuations. This is a subject with which I assume most of you are generally familiar and which I could discuss in detail only by consuming a great deal of time and going into a great many technicalities. The principal change which Rule 26 brought about in the pricing of open-end shares was to require pricing twice a day in place of the previous common practice of pricing only once a day. This change has, of course, cut down somewhat the possibility of dilution but without eliminating it. Whether it has or can reduce dilution to a practical minimum remains to be seen. We are currently making arrangements to study the operation of the rule, so that in the not too distant future the Commission can consider whether the rule should be allowed to remain in effect in its present form, or whether it should be modified, or whether the Commission should adopt its own rules on the subject.

Reference has already been made to Section 11 of the Investment Company Act which, generally speaking, requires SEC approval of exchange offers of open-end securities unless the exchange is made on the basis of relative net asset values, that is, without any sales load or other charges. Closely related to Section 11 are the provisions of Section 25 regarding reorganizations. The precise nature of the Commission's powers over reorganizations is a topic in itself, which I shall not attempt to discuss here.

Two other provisions have a definite effect upon the distribution machinery, though they do not relate to particular sales or sales practices. Section 15(b) of the Act requires that the contract between an open-end company and its principal underwriter be in writing, be non-assignable, be limited to a period of two years, and be continued thereafter only by specific approval given at least annually by the board of directors of the investment company or by a majority of its stockholders. Section 15 (c) requires that any directors' resolution, pursuant to which an underwriting contract is entered into or continued, be by vote of a majority of those directors who are not parties to the contract or affiliated with any such party. The significance of the latter provision is emphasized by another section of the Act, which requires that the board of directors of every management company have a majority made up of persons who are neither principal underwriters of the company's securities nor affiliated with any principal underwriter. It is hoped that these provisions may generate a little more interest in investment management among the management investment companies, and a little less interest in salesmanship. Incidentally, none of these latter provisions becomes effective until November 1st of this year.

So far I have not mentioned two aspects of the Investment Company Act which are most obviously related to the regulation of the distribution of shares. These are the provisions for registration statements and annual and other periodic reports, and the provisions relating to prospectuses and other forms of sales literature. Discussion of these has been omitted because they can most conveniently be considered in connection with the third section of my remarks, relating to the third of the three questions which were posted at the outset: where do we go from here?

At this point, in case you have any misgivings, it is not my intention to embark on a solemn discussion of "cooperation." Of course, I'm in favor of cooperation, just as Calvin Coolidge's preacher was against sin; but as Bob Kline pointed out at your convention in Dallas last year, discourses on this subject don't mean much unless you get down to brass tacks.

I have four simple, specific, concrete, moderate, and I believe practical, suggestions:

*First.* As a result of the Investment Trust Study --- five years of it --- we have a vast store of information, both general and particular, relating to investment companies. This information is being brought up-to-date by detailed registration statements, many of which have already been filed and are now being carefully examined. It will be kept reasonably up-to-date in the future by a system of annual and other periodic reports. Our resources are definitely limited, but we are probably in a better position than you to collect and compile this data. Please feel free to call on us for any information that you need, to treat us the way a Congressman treats the Library of Congress, the way a traveller treats the clerk in the information booth. We won't be able to help you every time, but we'll do everything we can.

*Second.* Your Association has a Committee on Investment Trusts. I have already had some correspondence with the former chairman of this Committee, John Martin of Ohio, and more recently with the present chairman, Mr. J. Myron Honigman of Pennsylvania, who unfortunately was unable to attend this convention. The immediate program of the Committee, as I understand it, is to see whether it isn't possible to work out a uniform system of annual and periodic reports for investment companies, and to use as a convenient starting point the reporting forms which the SEC will adopt under

the Investment Company Act of 1940. I have already promised to send to the Committee, for their comment, before they are promulgated, tentative drafts of all future reporting forms under the Investment Company Act. We are working on these forms now, and the tentative drafts should be out in a few weeks.

The prospects for this program are good, and I think it would be most unfortunate if it should fall by the wayside. It will be of advantage to all of us, because the companies are willing, and should be willing, to furnish more information than they have heretofore, if only they can furnish it on a uniform basis. But apart from any question of advantage to the regulators, it seems to me that the persons regulated are entitled to the convenience of uniform regulations when, as here, no local peculiarities of any consequence exists which justify diversity of treatment. We all have a stake in the system of administrative regulation which is now so common through the country; we all want to see it prove itself a just and workable arm of government. If we are to succeed, we must demonstrate that we know the difference between principle and detail, between substance and form. That means that we must consistently refuse to compromise principle or to sacrifice substance. But it also means that we must show ourselves willing and able to adjust details and to modify forms.

*Third.* In connection with uniform reporting it is natural to think of a uniform prospectus. How much can be done along that line it is hard to say; certainly the uniform prospectus presents many more problems than the uniform report. But the organization for attacking these problems is already in existence, in your Association's Committee on Investment Trusts, in the National Association of Investment Companies (whose Executive Director, Paul Bartholet, is here today) and in the SEC's Registration and Investment Company Divisions. I suggest that the attack be made.

*Fourth.* There is a certain amount of duplication between some state regulations and certain prohibitions in the Investment Company Act of 1940. It is not my business to suggest that any substantive regulation of any state should be modified because the same subject matter is covered by the Investment Company Act, and I am not making any suggestion to that effect. I understand, however, that certain states have considered it to their advantage to modify some of their regulations regarding matters covered by the Investment Company Act, so as to be able to devote more effort to matters not covered by the federal statute. If any other state commissions wish to take comparable action, I hope that they will feel free to call on us for any technical or other assistance which we are able to render. Conversely, if any state commissions are considering the adoption of a regulation which is similar to some provision of the Investment Company Act, we shall be glad to give them the benefit of our experience for whatever it is worth.